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RUEHCN/AMCONSUL CHENGDU 2169
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RUEHGZ/AMCONSUL GUANGZHOU 0627
RUEHHI/AMEMBASSY HANOI 0030
RUEHHK/AMCONSUL HONG KONG 2335
RUEHJA/AMEMBASSY JAKARTA 0024
RUEHML/AMEMBASSY MANILA 0092
RUEHMO/AMEMBASSY MOSCOW 0060
RHEHAAA/NATIONAL SECURITY COUNCIL WASHINGTON DC
RUEHUL/AMEMBASSY SEOUL 0530
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TREASURY FOR OASIA/INA -- DOHNER/HAARSAGER/WINSHIP
TREASURY FOR IMFP -- SOBEL/CUSHMAN
STATE PASS CEA FOR BLOCK
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E.O. 12958: N/A
TAGS: ECON CH EFIN EINV PGOV
SUBJECT: FEARS OF POLICY CHANGES DRIVE SHANGHAI STOCKS SLUMP

¶1. (SBU) Summary: The Shanghai stock market's recent 18 percent decline stems from three main factors, say ConGen Shanghai contacts: a more cautious Central Government stance regarding potential asset bubbles; profit-taking by some leading institutional investors; and an expected moderation to the flood of new money into the economy. Most contacts indicated surprise with the speed and extent of the drop since the market hit its year-to-date high on August 4 -- one experienced observer called it "shocking." Most see the market rebounding, with gains -- even if only small ones -- by the end of the year. End Summary.

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Background: The 2009 Rally
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¶2. (SBU) The Shanghai Composite Index this year gained roughly 90 percent through its peak of 3,471 on August 4. From that point through mid-day August 20, the index fell to 2844, or over 18 percent. Price-earnings ratios soared to 30:1, compared to an average of around 19:1 in the two years prior to the bubble and 15:1 at the beginning of the year. (Comment: The large run up can be attributed to (i) aggressive assumptions about a potential economic recovery, supported by a 7.9 percent GDP growth in the second quarter, (ii) the herd mentality of Chinese investors entering the market on the rebound, and (iii) expectations that the present loose monetary policy will continue. End comment.)

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Beijing Signals the Markets to Cool Down . . .
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¶3. (SBU) Our contacts say that policymakers are becoming wary of distortions in the Chinese economy as a result of the economic stimulus measures introduced in fall 2008. These include the interrelated problems of asset bubbles, which some contacts see in the equities market as well as in the real estate sector, market speculation, and the potential degrading of loan performance. According to Chinese press, Chinese regulators and state-owned banks became increasingly concerned that companies were funneling funds allocated for stimulus projects into the market. One contact at a European bank estimated that up to RMB1 trillion of the RMB4 trillion government stimulus spending may have made its way into the market. According to press, the Central Government responded to these potential issues with PBOC's second quarter monetary policy report, released on August 5, which indicated that tighter credit, increased scrutiny of loans, and a heightened focus on mortgage lending standards could be expected in the second half.

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. . . And What Beijing Says Matters
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¶4. (SBU) Many contacts have emphasized that the China market is shallow and driven by political decisions and is not a reflection of the macroeconomy. Over recent days, said two contacts, the government had been telegraphing "sell" signals to the market. One bank's chief economist for China said Chinese policymakers probably welcome the market correction, with some officials estimating a decline of around 20 percent could help

ease concerns of an asset bubble. A Shanghai-based investment advisor separately reinforced the notion that some parts of the bureaucracy appear to be talking down the market, following a typical playbook: first "water down" the shares in the market through the sale of non-traded shares and small IPOs, then through larger IPOs; if the market is still deemed too high, expect to see imposition of higher transaction taxes on stock trading, reversing tax cuts previously taken to support the market.

¶5. (SBU) Our contacts are divided on the importance of stock market performance to the Chinese leadership in advance of the 60th anniversary of the founding of the People's Republic of China on October 1. The head of securities trading at a firm affiliated with a Western bank emphasized the importance of the upcoming National Day celebration, and said that a pullout by insurance companies from the market appeared to be driven by a calculation that the Central Government would start to tighten monetary policy after the National Day anniversary, reinforcing the need to lock in profits now. The contact said that October was seen as being a definite "policy inflection point." However, a Shanghai-based investment adviser discounted the notion that the government would hold off changes until after October 1. He noted that the market fell prior to the Olympics, when some market players were hoping the government would prop it up.

¶6. (SBU) Still, Beijing may not want the market to fall much farther. The chief economist said the PBOC did not expect such a strong market reaction to the central bank's rhetoric. The head of an investment bank branch said that the Chinese government still wants some growth in the equities market, so the current Shanghai Composite Index level may be close to the bottom. (Note: As of August 20, market players sensed a shift back towards government support for a stable, if not growing, market, with Chinese press reporting that the China Securities Regulatory Commission has recently approved several stock-oriented funds. Analysts anticipate that this will bring more investors into the market. End note.)

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Institutional Investors Cashing in Gains
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¶7. (SBU) Several sources noted the movement by insurance companies to trim the equities weight in their portfolios as a trigger to the selloff. The head of a securities firm explained that insurance companies look for absolute gains, so that once they hit their annual target they decided to lock in profits. Since half of insurance companies' investments in the market are through fund managers, this in turn forced those funds to sell off holdings, and led to a downward spiral. Ping An Insurance started the selloff, said two contacts. The securities firm head said that retail investors, on the other hand, are generally loath to sell at a loss, and therefore many are holding on to their stocks until a rebound. An investment adviser made a similar call, saying that insurance companies and fund managers looked at the healthy second quarter results, and decided to liquidate their positions.

¶8. (SBU) The investment adviser pointed to an additional factor impelling investors to close out their positions. He said that since there is no way to short the market in China, the only way

to hedge risk is to sell off a position. Another contact at a U.S. bank echoed this sentiment. Mutual funds, hedge funds, and social security funds are changing their portfolio allocation, drawing down their equity holdings and moving into the bond market, she said. Increased capital inflows to the bond market reflect this trend, though it is uncertain how widespread and fixed this movement will be. The securities firm head said that--given the almost doubling of the market index this year--it was no surprise that there was some pullback.

¶9. (SBU) The decision by the People's Bank of China (PBOC) to begin "dynamic fine-tuning" was the perfect excuse for investors who believed stocks were already overvalued to cash-in on the equities market, according to the chief economist for China at a major Western bank. (Comment: High valuations and doubts about a timely recovery in the real economy, especially in light of the consumer price index falling 1.8 percent year-over-year and the producer price index down 8.2 percent, reinforce expectations that the PBOC will begin to draw back liquidity. End comment.)

¶10. (SBU) However, not all our contacts agreed that institutional investors are now waiting out the stock market. The head of China markets at a U.S. bank said institutional investors are still bullish, by-and-large, and they will probably re-enter the market again, in anticipation of a rebound.

Liquidity Flood Seems to be Moderating

¶11. (SBU) Some contacts pointed to anticipation of an end to monetary easing, or an impending start for monetary tightening, as a reason for the stock market slump. Many contacts pointed to concerns that sharp new lending growth in the first half had led to over-liquidity. Some observers already see an impact from the lower new bank lending in July. An investment adviser said that this had forced some companies to withdraw funds parked in the stock market in order to finance their investments in the real economy. The head of an international investment bank branch agreed, saying that there is a "zero sum liquidity effect" in which July's lower lending has led corporations to liquidate some stock holdings bought with the easy credit available earlier this year. The lead China analyst for a major bank said that the main driver of market fluctuations has been liquidity. He noted that some are waiting to see the August and September new lending figures to see if the PBOC has shifted towards a tighter monetary policy.

Comment

¶12. (SBU) Our contacts in Shanghai largely confirm that market insiders have been gaming the government's economic stimulus plan and flood of new infrastructure lending to make short-term profits on the stock market. With Beijing offering more money to favored companies than they could profitably invest in the real economy, chances were high that some of the funds would find their way into the stock market. Savvy investors were able to ride this wave up, but those ready to liquidate their positions before the government slammed closed the credit door

again would make the highest gains. That is why the July PBOC report rang a sell signal for the market, even if true monetary tightening does not begin for months -- everyone wanted to be the first one to the exit. Looking forward, most market players are now hoping for the Central Government to offer policy support to keep the stock market from falling farther.
CAMP